K&L UPDATE
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A Primer for Audit Committees after Sarbanes-Oxley

The enactment of the Sarbanes-Oxley Act of 2002 (the "Act") has subjected audit committees and their composition, responsibilities and functions to increased scrutiny. Companies are engaging in a comprehensive examination of all aspects of their audit committees, as well as the audit function. This Update focuses on the new duties and responsibilities facing audit committees in light of the Act and highlights ways in which the attorneys at Kirkpatrick & Lockhart LLP ("K&L") may provide guidance to audit committees in carrying out their expanded roles.

As indicated by rules adopted on April 2, 2003 by the Securities and Exchange Commission (the "SEC") and proposed changes to the listed company rules of the NYSE and NASDAQ in response to the Act, the new requirements relating to director independence generally will not apply to public companies that are not subject to the listed company rules of an exchange or of NASDAQ because they do not have a listed security, including those companies with securities that are traded "over-the-counter," but will apply to all companies with listed securities, regardless of size, including "small business" issuers who file reports with the SEC pursuant to Regulation S-B. Other provisions discussed in this Update, such as those relating to the oversight responsibilities of public company audit committees, will apply more broadly. For example, the new rules will require all public companies subject to the SEC's proxy rules to make certain proxy disclosures regarding the composition of their audit committees. Finally, while this Update primarily addresses the application of the Act and related regulations to domestic companies other than investment companies, the Act and other applicable provisions discussed in this Update will impact both foreign private issuers and investment companies, as well, and treat those types of issuers differently in certain respects. This Update does not address specifically the application of the Act to investment companies or foreign private issuers.

AUDIT COMMITTEE COMPOSITION

The Act, together with recently-proposed amendments to the NYSE and NASDAQ listed company standards, places substantially greater emphasis on the independence and inherent expertise of public-company audit committees and will mandate significant changes to the composition of those committees. Most notably, as discussed below, the new provisions and proposals modify the definition of "independence," limit the types of compensation that audit committee members may receive and require that public companies include "financial experts" on their audit committees. Although these provisions have not yet become effective, many companies are "early adopting" their requirements. In particular, companies contemplating imminent initial or follow-on public offerings should consider the impact of these rules on the composition of their audit committees.

The Act's Threshold Independence Requirements. The Act requires that each member of a listed company's audit committee be an independent member of the company's board of directors. For purposes of determining independence under Section 301 of the Act, rules recently adopted by the SEC[1] provide that:

- An audit committee member may not accept any consulting, advisory or other compensatory fee from the company or any subsidiary of the company, other than in the member's capacity as a member of the board of directors or any board committee. The acceptance of such disallowed fees by certain members of a director's immediate family or by a firm providing accounting, consulting, legal, investment banking or financial advisory services to the company or any subsidiary of the company in which the director serves as a partner, member or principal (other than a merely passive owner) also may undermine the director's ability to serve as an independent member of the audit committee[2]; and

- An audit committee member may not be an "affiliated person" of the company or any subsidiary of the company apart from his or her capacity as a member of the board of directors or any board committee. The SEC has adopted a "safe harbor" provision providing that any director who is not an executive officer or stockholder beneficially owning 10% or more of the voting equity securities of the issuer will be deemed not to be an "affiliated person" of that issuer[3]. The safe harbor will not create a presumption against the independence of directors who are unable to fit within its requirements and is not intended to cap stock ownership by an independent director. Rather, to the extent that a particular director does not fit within the safe harbor, that director's independence (or lack thereof) would be the subject of a further "facts and circumstances" analysis.

- Exceptions to these basic requirements include:

  - IPO Exception: The audit committee of a newly-listed company, such as a company which lists securities on a national exchange or with NASDAQ in connection with an initial public offering of those securities, must include at least one independent member at the time of listing. Such newly-listed companies must have audit committees comprised of a majority of independent directors within 90 days of listing and must meet the requirement for a fully independent audit committee within one year of their initial listing. In this respect, the SEC's final rules are broader than originally proposed.[4]

  - Exception for Subsidiary Board Service: The independent status of an audit committee member that sits on the board of directors of both a company and a any of its affiliates, including a direct or indirect subsidiary, is not affected by such dual service, if the audit committee member otherwise meets the independence requirements for both entities.

1 The Act amends Section 10A of the Securities Exchange Act of 1934, as amended (the 'Exchange Act"), to require that the SEC adopt regulations directing the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not comply with the independence standards articulated in the Act. During its April 2, 2003 Open Meeting, the SEC adopted rules that contemplate implementation of the Act's independence standards by the national securities exchanges and associations. The SEC adopted these rules substantially as proposed, with certain exceptions, as reflected in the text of the final rules.

2 This prohibition does not extend to fixed amounts of compensation (including deferred compensation) under a retirement plan for prior service to the company that is not contingent upon continued service.

3 Executive officers, employee directors, general partners and managing partners of any beneficial owner of 10% or more of an issuer's voting equity securities (*i.e.*, an affiliate of the issuer) will be deemed to beneficially own those securities, as well, and consequently, will not fit within the safe harbor. The SEC originally proposed also to exclude directors who are the "designees" of an issuer affiliate from the protection of the safe harbor, but explicitly declined to do so in its final rules.

4 The SEC's original proposal would have permitted one non-independent director to serve on the audit committee of a newly-listed issuer at the time of listing and would have required full compliance with the new rules within 90 days.

Companies should recognize that, to the extent that they rely on an exemption from these independence requirements, they will be required to make certain disclosures to that effect in their proxy statements.

The SEC's rules will require listed companies to comply with these minimum independence standards no later than their first annual meeting of stockholders held after January 15, 2004, and in any event, no later than October 31, 2004, **except** that foreign issuers and "small business" issuers will have until July 31, 2005 to become compliant.

Further Independence Requirements Proposed by the NYSE and NASDAQ. The NYSE and NASDAQ each have proposed changes to their listed companies rules that both implement and expand upon the threshold independence requirements imposed by the Act and related SEC rules.

The NYSE's current corporate governance rules already require that a listed company's audit committee be comprised solely of independent directors. The NYSE Corporate Governance Rule Proposals, which were released on August 1, 2002 and amended on April 4, 2003 (but which have not yet been approved by the SEC), will require that independent directors make up a majority of the **entire board** of a listed company, as well as the entire audit committee[5]. According to the proposed rules, independent directors, including the members of the company's audit committee, will be required to meet the following independence standards:

- The company's board of directors must **affirmatively determine** that a director has "**no material relationship**" to the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) for the director to be deemed "independent." Material relationships include, among other things, commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships and must be considered not only from the standpoint of the director, but from that of persons or organizations with which the director has an affiliation, as well. The NYSE has stated that, as the concern is independence from management, it does not view ownership of a significant amount of stock, by itself, as a bar to a finding of director independence.
- Companies must disclose these independence determinations in their proxy statements, and if a company's board of directors determines that a particular relationship is not "material," the company must publicly disclose the basis for that determination. Alternatively, a board of directors may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards.
- Former employees and affiliates of the company's present or former independent auditors and former employees of any other company whose compensation committee includes an executive officer of the listed company (together with certain immediate family members of all of the foregoing), will be subject to a **five-year** "cooling off" period before they can be considered independent.
- Any director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company (other than customary director and committee fees and certain kinds of deferred compensation) also will be subject to a five-year cooling off period.
- A five-year cooling off period also will apply to any director who is an executive officer or employee of, or has an immediate family member

5 The NYSE's April 4, 2003 amendment to its proposed rule changes clarities that limited parnterships and companies in bankruptcy will not be subject to this requirement.

who is an executive officer of, another company (a) that accounts for at least 2% or $1 million (whichever is greater) of the company's consolidated gross revenues or (b) for which the company accounts for at least 2% or $1 million (whichever is greater) of its consolidated gross revenues.

In addition to meeting these independence standards, audit committee members will be prohibited from receiving any compensation from the company other than customary directors' fees. Disallowed compensation will include fees paid directly or indirectly for services as a consultant or as a legal or financial advisor, regardless of amount.

As proposed, the NYSE rules would allow listed companies 18 months from the date of their adoption to become compliant with these new independence standards. As noted above, the SEC's recently adopted rules will require listed companies (as a general matter) to comply with the minimum independence standards mandated by the Act no later than their first annual meeting of stockholders held after January 15, 2004. For most public companies with December 31 fiscal year ends, the SEC's rule thus would require compliance with at least the Act's threshold standards by the Spring of 2004. Although it has not yet done so, the NYSE indicated in its April 4, 2003 release that it ultimately will amend its proposal to conform to the SEC's final rule. Thus, NYSE-listed companies should be aware that the currently proposed 18-month grace period is likely to change, at least to the extent that it specifically applies to audit committee composition, and possibly with respect to proposed changes to the NYSE's listing standards not explicitly mandated by the new SEC rules, such as, for example, the NYSE's proposed requirement that independent directors comprise a majority of the members of the boards of directors of its listed companies.

The NASDAQ's current listed company standards also generally mandate that NASDAQ-listed companies maintain audit committees comprised entirely of independent directors (subject to certain limited exemptions under "exceptional and limited circumstances," which may trigger additional proxy disclosure requirements). On February 26, 2003, NASDAQ released a summary of its corporate governance rule proposals, including proposed revisions to its earlier proposals of October 9, 2002. In the summary, NASDAQ proposed that the rules be effective with a company's first annual meeting occurring after January 1, 2004. Like the NYSE proposal, the NASDAQ's proposed rules would require that independent directors form at least a majority of the entire board of a listed company, in addition to the audit committee.[6] The SEC has not yet approved NASDAQ's proposed rule changes. According to NASDAQ's proposal, audit committee members will continue to be required to meet the NASDAQ independence definition set forth in Rule 4200(a)(14), as amended by the proposed rules, which will provide that:

- A director is not independent if <u>any</u> family member of the director is employed as an executive officer of the company or a parent or subsidiary of the company, or has been so employed within the past three years;
- A director of either a for-profit or a not-for-profit company is not independent if the company makes payments to an entity where the director is an executive officer and such payments exceed the greater of $200,000 or five percent of the recipient's gross revenues;
- For a three-year "cooling off" period, former partners or employees of the outside auditors who worked on a company's audit engagement may not be considered independent;

6 As proposed, the NASDAQ rules would maintain NASDAQ's current exemption for "exception and limited circumstances," which, subject to certain caveats, may allow one non-independent, non-employee director to serve on the audit committee (but not as the chairperson of the committee) for a period no longer than two years.

- Also for a three-year "cooling off" period, a director may not be considered independent if he or she is an employee of a company whose compensation committee includes an executive officer of the listed company; and

- The same three-year cooling off period will apply to any director to the extent that the director, or a family member of the director who is not an employee of the company, receives any payments from the company in excess of $60,000, other than for board service.

In addition to meeting these general independence criteria, an audit committee member would be prohibited from receiving any payment from the company other than payment for board or committee service, consistent with Section 301 of the Act. Furthermore, a director would be prohibited from serving on the audit committee if he or she is deemed an "affiliated person" of the company or any subsidiary, consistent with Section 301 of the Act. In this regard, audit committee members would be prohibited from owning or controlling 20% or more of the company's voting securities, or such lower number as may be established by the SEC in rulemaking under Section 301 of the Act, and for this purpose will be deemed to own securities held by their employer, so that an employee of an entity that owns or controls 20% or more of a company's voting securities will be ineligible to serve on the audit committee. However, NASDAQ has noted that for all other purposes, share ownership would not, by itself, undermine a director's independence.

NASDAQ proposed that its proposed independence standards be effective with a company's first annual meeting occurring after January 1, 2004, which, though not conforming precisely, is similar to the compliance schedule imposed by the SEC's new rule.

The Act's Mandate for Audit Committee Financial Expertise. The Act also directs the SEC to adopt rules requiring that all public companies (including listed companies as well as public reporting companies that do not have any security listed on a national securities exchange or on NASDAQ) disclose whether or not (and if not, why not) their audit committees include at least one member who qualifies as a "financial expert," as defined by the SEC. Recently-adopted SEC rules require that public companies disclose in their annual reports for each fiscal year ending on or after July 15, 2003, whether their audit committees include at least one "audit committee financial expert," and, if so, the name of the audit committee financial expert. Each public company must also disclose whether the financial expert is "independent," as defined in the listing standards of a national securities exchange or association.

The SEC's rules define an "audit committee financial expert" as a person who has all of the following attributes:

- an understanding of financial statements and generally accepted accounting principles;
- an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by a company's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

A person can acquire these attributes through:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve similar functions;

- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

The SEC rules provide that an audit committee financial expert will not be treated as, or have the potential liability of, an "expert" for purposes of the federal securities laws. The SEC has not imposed on audit committee financial experts any duties, obligations or liability greater than, or different from, the duties, obligations and liability of other audit committee members. The SEC rules also provide that the designation of one or more members of a company's audit committee as an audit committee financial expert will have no effect on the duties, obligations or liability of any other audit committee member or the company's board of directors.

THE AUDIT COMMITTEE'S OVERSIGHT RESPONSIBILITIES

In addition to enhancing the independence requirements imposed upon audit committee members, by adding new Section 10A(m) to the Exchange Act, the Act requires the SEC to direct the national securities exchanges and associations to prohibit the listing of any security of any company that does not comply with the following:

- Each audit committee must be directly responsible for the appointment, compensation and oversight of the work of any public accounting firm employed by the company for the purpose of preparing and issuing the company's audit or related work, including resolving disagreements between management and the auditor regarding financial reports;
- Each audit committee must establish procedures for handling complaints regarding accounting, internal controls or auditing matters;
- Each audit committee must possess the authority to engage outside advisors, such as legal and other advisors; and
- Each company must provide appropriate funding to compensate its outside auditors and enable its audit committee to engage other advisors.

The Act also requires that a company's audit committee must pre-approve all audit **and** non-audit services (except for certain *de minimus* non-audit services) provided to the company by its auditor. In exercising its pre-approval responsibilities, an audit committee may either consider and pre-approve services on a case-by-case basis or may establish detailed policies and procedures according to which the company may engage its auditors to perform audit and non-audit services.

The Act prohibits an auditor that performs an audit for a company from providing to that company, contemporaneously with the audit, the following "non-audit" services:

- bookkeeping or other services related to the accounting records or financial statements of the company;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment advisor or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service the Public Accounting Oversight Board determines is impermissible.

Other than these prohibited activities, the Act allows a public accounting firm to perform any non-audit service, including tax services, for an audit client, but

only if the service is approved in advance by the client's audit committee.

The SEC has also enacted a number of rules relating to, among other things, audit partner rotation, employing former auditors, compensation of audit partners, retention of records relevant to audit reviews, and disclosure of fees paid for audit services, audit-related services, tax services and other services.

HANDLING COMPLAINTS

The SEC has adopted rules that implement, among other things, the Act's requirement that the audit committees of companies with securities listed with a national securities exchange or association establish and maintain procedures for:

- the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters; and
- the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

However, the SEC's rules explicitly do not mandate any specific procedures that listed companies must undertake. Rather, the SEC proposes to build sufficient flexibility into its rules to allow companies the latitude to "develop and utilize procedures appropriate for their circumstances." In light of the anticipated flexibility of the SEC's final rules, companies are considering, among other things, various mechanisms for "filtering" complaints through their internal audit or legal personnel, to avoid inundating their audit committees with frivolous matters while ensuring that legitimate complaints are duly reviewed and addressed.

INDEPENDENT ADVISORS

Audit committees traditionally have relied on the company's independent auditors, the company's own in-house legal counsel and the company's outside legal counsel for advice and input on a variety of issues. Audit committees customarily have not retained independent advisors, except in unusual circumstances, such as in connection with possible accounting irregularities or other significant internal issues or investigations.

In light of the directives of the Act and the rules implementing the Act, however, many audit committees increasingly will consider retaining independent advisors solely to advise and act on behalf of the audit committee. In fact, the SEC's recently adopted rules specifically require that audit committees have the authority to engage outside advisors, including counsel, and that issuers make available appropriate funding for this purpose. Many audit committees may engage outside advisors out of an abundance of caution and others in response to increased pressures from stockholders and regulatory agencies such as the NYSE, NASDAQ or SEC, among others. Audit committees may turn to their own advisors to test the advice received from a company's traditional advisors on customary matters or to determine if an independent investigation is necessary. In addition, audit committees may need to retain other outside experts to assist them in fulfilling their duties. K&L's broad experience in corporate governance issues, internal investigations and securities enforcement matters, uniquely positions K&L to counsel audit committees.

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